Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Bill Number: AB 841

Related Bills: See legislative history
Telephone: 845-6978
Introduced Date: 2/24/99

Attorney: Doug Bramhall
Sponsor:

SUBJECT: 1999 California Land & Water Conservation Pilot Project Qualified Donations Credit/Nonrecognized Gain On Sale Of Property

SUMMARY

This bill would establish the California Land and Water Conservation Pilot Project of 1999 within the Public Resources Code (PRC) and would establish tax credits within the Revenue and Taxation Code. This analysis addresses the provisions of the bill that pertain to the tax credits.

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a tax credit to taxpayers who donate property (as defined) to the state, any local government, or to any nonprofit organization designated by the state or local government. The amount of tax credit under the PITL would range from 65% to 85% of the fair market value (FMV) of the donated property. The amount of tax credit under the B&CTL would be 65% of the FMV of the donated property.

Also under the B&CTL, a seller would not have to recognize gain on the sale of that property if the purchaser contributes it within 90 days of the purchase to the state, a local government, or a nonprofit organization, pursuant to the pilot project established by this bill.

EFFECTIVE DATE

This bill would apply to a qualified contribution made on or after July 1, 2000, and before January 1, 2004.

LEGISLATIVE HISTORY

SB 2080 (1998); SB 87 (1997); SB 1280 (1995/1996)

BACKGROUND

The Resource Conservation Division of the California PRC provides for expending state, county, city, district, or other public funds for projects that will save the soil, water, air, and basic resources of the state from unreasonable and economically preventable waste and destruction. The PRC provides directors of the resource conservation districts authority to acquire property through purchase, lease, contract, or gift. Land acquisitions are funded by various special funds and general obligation bonds.

Board Position:			Department Director	Date
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The California Endangered Species Act, enacted in 1984, outlines the state's policy to conserve, protect, restore, and enhance any endangered species or any threatened species and its habitat. The legislation's stated intent was to acquire lands for habitat for these species. Additionally, the act states that all state agencies, boards, and commissions must seek to conserve endangered species and threatened species and must use their authority to further the purposes of the act.

Voters adopted the California Wildlife Protection Act of 1990. This act states that because wildlife and fisheries conservation is in the public interest, it is necessary to keep certain lands as open space and in natural condition to protect significant environmental values of wildlife and native plant habitat, riparian and wetland areas, native oak woodlands, and other open-space lands. The funding to accomplish these goals is provided through the continuously appropriated Habitat Conservation Fund. Moneys are transferred into this fund from various sources, including the Cigarette and Tobacco Products Surtax Fund, the California Environmental License Plate Fund, and the Fish and Game Preservation Fund. If the annual amount transferred from these funds does not equal $30 million, the difference is transferred from the General Fund. All state officials are required to implement the act to the fullest extent of their authority.

SPECIFIC FINDINGS

Current federal and state tax laws provide for various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child and dependent care credits) or to influence business practices and decisions or achieve social goals. Credits generally are based on a percentage of tax expenditures by the taxpayer. Currently, no existing federal and state laws provide income tax credits for the contribution of property to state or local governments. Additionally, no federal or state laws provide a tax credit for up to 85% of the value of property, without regard to the original cost or current tax basis of such property to the taxpayer.

Under **current federal and California state law**, contributions of property qualify as charitable contributions if the property is contributed to or for the use of qualified organizations (public, private or governmental), as follows:

- For corporations, **existing federal and state law** allows a deduction for charitable contributions, limited to 10% of the taxpayer’s net income (except as specified). Contributions in excess of 10% may be carried over to the following five succeeding income years. Under state law, the amount of a contribution is limited to a taxpayer’s basis in the property contributed.

- For individuals, both **federal and state laws** allow a deduction for charitable contributions. The amount generally deductible for a contribution of appreciated real property (normally capital gain property) is equal to the FMV of the property on the date of contribution. For contributions to certain types of charitable organizations, including governmental units, the allowable deduction is limited to 50% of the taxpayer’s adjusted gross income (AGI). However, for other types of charitable organizations, the deduction may be limited to 30% of the taxpayer’s AGI. If the charitable contribution amount exceeds 50% (or 30%) of the taxpayer's AGI, the taxpayer may carryover the excess amount up to five years.

For a charitable gift of ordinary income-type property, the amount considered contributed (the property's FMV) must be reduced by the amount of ordinary income or short-term capital gain that would have been recognized if the property had been sold by the donor for its FMV.

Ordinary income-type property is property, like inventory for example, which would have resulted in some amount of gain, other than long-term capital gain, if sold at its FMV on the date it was contributed.

California law generally conforms to federal law relating to gain or loss on the disposition of capital assets. **Federal and state law** provide that capital assets are property other than: stock in trade or other inventory-type property held primarily for sale to customers; depreciable or real property used in a trade or business (i.e., "Section 1231 Property"); copyrights and other literary property; accounts or notes receivable acquired in the ordinary course of business; and U.S. government publications, as specified.

Generally, capital gain is realized and recognized when a capital asset is sold or exchanged and the amount realized exceeds the adjusted basis of the asset (and, in certain situations, the amount subject to recapture under federal law). Adjusted basis in a capital asset is generally determined by the cost of the asset (when capital assets are acquired in certain non-recognition transactions, adjusted basis may be a carryover or substituted basis) and is increased by further investment or decreased by allowable deductions (such as depreciation). Capital losses occur when a capital asset is sold or exchanged and the amount realized is less than the adjusted basis of the asset. Generally, a gain or loss from the sale or other disposition of property that does not qualify as a capital asset is ordinary gain or loss (other than gain from the sale of Section 1231 property), and similarly, a sale or other disposition of a capital asset in a transaction that does not qualify as a "sale or exchange" also generates ordinary income.

Under recent amendments to **federal law**, the maximum tax rate applicable to net capital gains for assets held more than one year was reduced from a maximum rate of 28% to 20% and to 10% for individuals, estates, and trusts who would pay tax at the 15% marginal rate. Beginning after the year 2000, federal law reduces these maximum capital gains rate for individuals to 18% (for those who would otherwise pay 20%) and 8% (for those who would otherwise pay 15%), provided the asset has been held more than five years.

Under current **California tax law**, capital gains for corporate and noncorporate taxpayers are taxed at the same rates as ordinary income, with no reduced capital gain rate (except that current PITL contains a 50% exclusion for gain recognized from the sale of qualified small business stock).

This bill would establish the California Land and Water Conservation Pilot Project of 1999 to encourage donations of land within the San Joaquin River Parkway to the state, local governments, or designated nonprofit organizations.

Under the PRC, **this bill** would limit to $10 million per fiscal year the dollar amount worth of property that could be accepted by the Secretary. The Secretary could not accept any property until authorized by the Legislature via the annual Budget Act or applicable legislation implementing the annual Budget Act.

Under PITL and the B&CTL, **this bill** would provide an income tax credit equal to the "qualified percentage" of the FMV of any "qualified contribution" made by a taxpayer to the state, any local government, or nonprofit organization designated by the state or local government to receive property pursuant to the California Land and Water Conservation Act Pilot Project. Within the PRC, this bill provides definitions and criteria under which property may be contributed, which will be discussed in this analysis as they apply to the department.

This bill would require that contributed property must meet the federal charitable contribution deduction provisions. If the contribution is approved by the Secretary of the Resources Agency, the contributor may receive a credit equal to a sliding scale of 65% to 85% of the FMV for property contributed beginning July 1, 2000. For PIT taxpayers:

if AGI is:	percentage is:
Not over $40,000	85%
Over $40,000 but not over $50,000	80%
Over $50,000 but not over $60,000	75%
Over $60,000 but not over $70,000	70%
Over $70,000	65%

For B&CT taxpayers, **this bill** would allow a credit for 65% of the FMV of the qualified property. No gain would be recognized on the sale of property if, within 90 days after the seller transfers the property, the purchaser contributes property under the terms of this bill.

The credit must be reduced by an amount equal to the FMV of any property interests or other consideration received by the taxpayer in exchange for the contribution.

This credit would be allowed to reduce regular tax below tentative minimum tax for purposes of alternative minimum tax through 2003. Any credit in excess of tax could be carried forward to reduce tax liability, but not below minimum tax, in subsequent years until the credit amount is exhausted.

The credit would be in lieu of any other state credit or deduction that the taxpayer would otherwise be allowed for the contributed property or interest therein.

If the property is used for another purpose than for which it was originally acquired, the agency owning the property shall pay to the state the amount of the original tax credit, plus interest since the time the credit was claimed.

Policy Considerations

This bill would provide different treatment between taxpayers for making the same type of contribution. Taxpayers under the PITL could receive a significantly higher credit amount, but only if their income is low, while corporate taxpayers would receive a flat percentage regardless of their own income. However, this difference is apparently consistent with the intent of providing the contributor 100% of FMV when both state and federal tax incentives are combined to fund the pilot project to obtain land for environmental reasons.

This bill would allow only corporate sellers, and not individual sellers, of subsequently donated property to avoid recognition of gain on a sale of such property.

This bill would provide a credit for donating land and/or property rights equal to 65% to 85% of the value of the property, making a land contribution six to eight times more valuable than any other kind of donation. Additionally, in combination with the federal deduction for a charitable contribution, this credit would provide some taxpayers tax benefits of almost 100% of the value of the donated land or water rights, without any regard to the taxpayers cost of the property.

The nonrecognition of gain provision of this bill would allow a B&CT taxpayer to sell the property and receive the proceeds free of state tax. The purchasing party also would receive the credit upon donating the property within 90 days of the acquisition. This results in a double tax benefit for what essentially is the same transaction since the donation is required to be made so quickly after the acquisition of the property. Moreover, since there is no limitation on to whom the seller may sell the property, it would be possible for related taxpayers to structure a sale followed by a donation to obtain this double tax benefit within the same related corporate structure. Further, the total exclusion of gain far exceeds prior preferential state treatment for capital gains, which allowed exclusion of only a portion of capital gains.

AMT was established to ensure that taxpayers with economic income pay some amount of tax. One-half of the existing small business stock exclusion is an AMT preference item. Prior to the Tax Reform Act of 1986, the amount of any capital gain deduction (for federal purposes) or exclusion (for state purposes) also was a tax preference item. This bill does not treat the proposed capital gain exclusion for qualified property as a tax preference item.

Implementation Considerations

The department has identified the following implementation considerations and department staff is available to assist in the resolution of these and any other issues identified.

- The qualified contribution must be accepted by the Secretary and approved by the Legislature. Generally, when another state agency is handling items which are eligible for a credit, the agency is required to provide the FTB with verification, such as the names of the recipient and the donor, the donor's taxpayer identification number(s), and the qualified credit amount. An alternative would be for the Secretary to provide verification to the taxpayer, who could provide it to the FTB upon request. Also, the author may wish to consider adding a requirement that the if the property was purchased within 90 days from a corporation, the purchaser discloses the corporation name and the date and location of purchase, and that the corporation receives verification from the Secretary that its gain should not be recognized.

- Section 37014 defines a "qualified donation" and the tax credits authorized by this bill are based upon the existence of a qualified donation. There are additional provisions with the pilot project that restrict property from acceptance by the Secretary. For example, Section 37009 provides that property may not be accepted by the Secretary if the land is otherwise required to be donated as a condition of development. In the event land is accepted without knowledge of developmental set-aside requirements, the tax credits are authorized notwithstanding that the property may not be qualified. If this is not the author's intention, amendments may be necessary to more closely tie the Resource Code and Tax Code definitions together.

- Credits are typically used within eight years of being earned. Since this credit does not have a carryover limit, the department would be required to retain the credit carryover on the tax forms indefinitely.

- The Secretary is authorized to accept property, defined to include only property for which a deduction under IRC Section 170 is permitted. Apparently the Secretary is to make a determination on the eligibility of a tax deduction. If FTB staff disagreed in connection with an audit of the claimed credit, disputes would arise with taxpayers caught in the middle.

Technical Considerations

Both the pilot project and the tax incentives are repealed on January 1, 2004. The amendment to Section 17039 in Sec. 2 of the bill provides a repealer on January 1, 2004, and Section 3 of the bill becomes operative on January 1, 2004, leaving both sections operative for a day. Section 2 of the bill should be repealed on December 31, 2003, to avoid this problem. Further, the operative date of Section 3 should be expressed in terms of its application to taxable years, rather than as of a specific date. The same issues exist with respect to the B&CTL provisions.

The actual credit language allows taxpayers a credit equal in amount to a specified percentage "of the FMV of any qualified donation"; however, if the amount of a qualified donation is to be certified by the Secretary of the Resources Agency, the actual credit language should eliminate the reference to FMV and instead directly tie the allowable credit amount for each taxpayer to the amount that is actually certified by the Secretary of the Resources Agency. Otherwise, disputes may arise with taxpayers in circumstances where a taxpayer is able to obtain an appraisal of FMV that differs from that assumed by the Secretary of the Resources Agency in certifying that a contribution is a "qualified contribution."

FISCAL IMPACT

Departmental Costs

With resolution of the implementation considerations, department costs should not be significant.

Tax Revenue Estimate

This bill would have no revenue impact unless the Legislature appropriates the money, as specified under this bill.

The revenue impact shown in the following table is assuming that the legislature would appropriate the necessary funds to obtain $10 million in donated property value.

Fiscal Year Cash Flow Impact Effective For Donations Made On Or After 7/1/2000 $ Millions		
2000/2001	2001/2002	2002/2003
($5)	($7)	($7)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

The revenue impact for this bill will be determined by the value of property that might be donated in any given year and the tax liabilities of donors for applying tax credits.

This estimate was developed in the following steps. First, it was assumed that a maximum amount of $10 million in qualified property would be donated within each fiscal year. Second, the average amount of credit would amount to 75% of the FMV for personal income tax filers and 65% for corporations. Third, the contributors would be able to use 75% of the qualified credit amount per year. Unused carryover credits were applied at the rate of 75% per year. The amount of gains that would have otherwise been reported on sales of property is unknown, but would probably not be particularly significant.

BOARD POSITION

Pending.